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Reform of Domestic Indirect Tax Systems in
Low-Income Countries: The Case of Nepal

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Table of Contents

- I. Introduction
- II. Revenue Importance
- III. Guiding Principles of Domestic Indirect Tax Reform
- IV. Domestic Indirect Tax Reform in Nepal in the 1990s
 - A. Excises
 - 1. Policy
 - 2. Administration
 - B. Sales Tax
 - 1. Policy
 - 2. Administration
 - C. Minor Domestic Indirect Taxes
- V. Adoption of VAT
 - A. Rationale for VAT in Low-Income Countries
 - 1. Broaden the Tax Base
 - 2. VAT and Tax Neutrality
 - a. Incentive to Restructure Business to Avoid Taxation
 - b. Tax Cascading/Pyramiding
 - c. Relative Tax Burden of Domestically Produces Goods and Imported Goods
 - d. Taxation of Exports
 - 3. Establishing and Account-Based System of Taxation
 - B. VAT Design for Low-Income Countries
 - 1. Type of VAT
 - 2. Methods of Tax Computation
 - 3. Tax Credit Mechanism
 - 4. VAT Coverage in Terms of Stages of Production and Distribution
 - 5. Geographical Coverage
 - 6. Rate
 - 7. Exemptions
 - 8. Zero Rating versus Exemption
 - 9. Treatment of Special Sectors, Organizations, and Transactions
 - a. Agriculture
 - b. Financial and Insurance Services
 - c. Immovable Property
 - d. Government, Government Enterprises, and Local Authorities
 - e. Charitable and Nonprofit Organizations
 - f. Small Vendors
 - 10. Administrative Procedures
 - a. Registration
 - b. Invoices and Bookkeeping
 - c. Return
 - d. Payment
 - e. Refund

- f. Appeal System
- C. VAT Development
- D. Taxpayers Education Program
 - 1. Interaction Programs
 - 2. Brochures, Articles, Posters, and Video Films
 - 3. Visits/Telephone Calls, Etc.
- E. Administration, Computerization, and Training
 - 1. Organizational Structure
 - 2. Computerization
 - 3. Personnel System
 - 4. Training
- F. VAT Implementation
 - 1. Registration
 - 2. Return Submission/Non-Filers
 - 3. VAT Visits/Audits
 - 4. Revenue Collection
- G. Concluding Observations
- VI. Bibliography
- VII. Appendix 1
- VIII. Appendix 2
- IX. Endnotes

List of Tables

- 1. Relative Importance of Domestic Indirect Taxes in Selected Countries
- 2. Relative Importance of Domestic Indirect Taxes in the Nepalese Tax Structure (1990/91–1997/98)
- 3. Composition of Domestic Indirect Tax Revenue
- 4. The Date of the Introduction and the Existing Rate(s) of VAT in Different Countries

Introduction

Indirect taxes on goods and services have always been an important part of any tax system. This is even more so the case in low-income developing countries where indirect taxes on internationally traded commodities have been critical sources of revenue. Domestic indirect taxes represent all taxes on the sale, purchase, or use of the goods and services within a country. As a country develops and international trade flows become further liberalized, the taxes on internationally traded commodities become less important. This pattern results in a greater reliance on domestic indirect taxes for revenue purposes.

This paper focuses on the appropriate policies for the domestic indirect tax system in low-income countries. While the analysis is illustrated by the example of the policies and reform process adopted by Nepal, many of the issues discussed are present in such reforms in a wide spectrum of low-income countries. It is clear from our analysis that many of the traditional prescriptions for the design of a domestic indirect tax system in advanced industrial countries must be substantially modified to make them operational in such low-income developing countries.

Low-income countries have relied heavily on excise duties and sales taxes for revenue purposes. In the past, excise duties were levied only on the domestic production of commodities. Today this concept has changed somewhat because excise duties are now levied on both domestically produced and imported goods. Excise duties are divided into three main types: sumptuary, luxury, and benefit excises. Excise duties levied to reduce the consumption of goods involving socially undesirable effects are known as sumptuary excises. Excise taxes on tobacco products and alcoholic beverages are common examples of such taxes. Excise duties levied on goods “not considered to be essential for a minimum standard of living” are called luxury excises; the rationale for these excises is that consumers of luxury goods (who generally belong to higher-income groups) ought to contribute more to government revenue. These taxes tend to be relatively revenue-elastic with respect to income growth. Benefit excises are levied on gasoline, vehicles, tires, etc.; the revenue from this type of excise tax is frequently used for road construction and maintenance. Excise duties are specific in nature—they are levied on specified

commodities, and often at specific rates. Although *ad valorem* excise taxes are preferred, as the tax revenue will not be eroded to the same extent by inflation, they cause the private sector to make changes in the organization of business so as to lower the applicable price at the point of taxation through transfer pricing.

Taxes levied on the sale of commodities are known as sales taxes. They are generally levied on the sale of a wide range of commodities. Unlike excise duties, sales taxes are commonly levied on all goods and services with the exception of those specifically exempted. Sales taxes can be divided into three main categories: turnover, single-stage and value added taxes. A sales tax levied on sales at each stage in the process of production and distribution, without giving credit for taxes paid at earlier stages, is known as turnover tax. A single-stage tax is levied on the sale at a particular stage in the process of production and distribution. A single-stage tax levied on the sales by manufacturers is called a manufacturer sales tax, while a tax levied on the sales by wholesalers is called a wholesale tax. Retail sales taxes are taxes levied on the sales by retailers to consumers. Finally, a value added tax (VAT) is levied on the value added by each firm in its production and distribution activities. Thus, just like the turnover tax, the VAT is levied at each stage in the chain of production and distribution; however, unlike the former—which is imposed on the total sales value at each stage—VAT is effectively levied only on the value added at that stage.

A purchase tax refers to the tax on the purchase of commodities, while a use tax applies to commodities bought elsewhere but used or stored in the respective state. The rationale behind the latter is that in a federal system, consumers may avoid a sales tax if they can buy similar commodities tax-free from neighboring states, either by mail or on the Internet. The states face restrictions in their capacity to impose sales tax on goods and services involved in interstate trade. Thus, a use tax is imposed over the general sales tax to avoid interstate sales tax evasion.

Revenue Importance

Domestic indirect taxes are important sources of revenue for governments in low-income countries. Sometimes they are the largest source of revenue. As with consumption-based taxes, these taxes are applied to large sections of the population and are relatively easy to administer. For example, these taxes generate almost half of the total tax revenue in Nepal, and over 50 percent of that in Sri Lanka. The relative importance of the domestic indirect taxes in selected low-income and middle-income countries may be seen below.

Table 1. Relative Importance of Domestic Indirect Taxes in Selected Countries

<i>Country</i>	<i>Domestic indirect tax revenue as percentage of total tax revenue</i>
<u>Low-Income Countries</u>	
Ethiopia (1995)	21.26
Maldives (1997 p.)	30.20
India (1997 p.)	36.04
Bhutan (1997)	36.79
Pakistan (1995)	46.74
Nepal (1998)	47.55
Sri Lanka (1997 p.)	61.65
<u>Middle-Income countries</u>	
Philippines (1997)	32.36
Indonesia (1996 p.)	34.13
Thailand (1997 p.)	47.42
El Salvador (1997)	57.42

p. = provisional

Source: *Government Finance Statistics Yearbook 1998*, International Monetary Fund (IMF), Washington, D.C.

Given the nature of the Nepalese economy it is likely that the domestic indirect taxation will remain an important source of the revenue in the years to come. With the reduction in the relative position of international trade taxes and considering the difficulties in generating additional income tax revenue, the relative importance of the domestic indirect taxes is likely to increase in the future.

Table 2. Relative Importance of Domestic Indirect Taxes in the Nepalese Tax Structure (1990/91- 1997/98)

Fiscal Year	<u>Domestic Indirect Taxes as Percent of</u>		
	Total Tax Revenue	Total Revenue	GDP
1990/91	46.31	35.28	3.26
1991/92	50.29	36.75	3.43
1992/93	49.25	37.91	3.47
1993/94	47.50	37.29	3.81
1994/95	45.00	36.00	4.21
1995/96	45.02	34.97	4.07
1996/97	44.55	35.82	4.03
1997/98	44.04	34.69	4.00

Source: Economic Survey 1998/99, Ministry of Finance, His Majesty's Government of Nepal, Kathmandu.

As indicated in Table 2, in 1997/98 domestic indirect taxes provided 44.04 percent of the total tax revenue, equal to 4 percent of GDP.

Of the domestic indirect taxes, the sales tax has been by far the most important source of government revenue; after its conversion into the VAT, it will probably be an even more important source of revenue in the years to come. As indicated in Table 3, the relative importance of excise taxes has decreased slightly in the second half of 1990s. These trends are in line with the government's policy to rely more heavily on the sales tax/VAT and less on excises.

Table 3. Composition of Domestic Indirect Tax Revenue
(Rs in million in 1983/84 price)

Taxes	90/91	91/92	92/93	93/94	94/95	95/96	96/97	97/98
Excises	607	591	558	561	543	589	646	780
Sales tax	1025	1188	1320	1654	1975	1948	2002	1925
Entertainment tax	20	16	20	39	30	30	32	25
Hotel tax	59	80	86	77	75	86	85	12
Air flight tax	239	74	79	96	91	94	88	93
Contract tax	88	89	113	125	165	186	174	206
Vehicle tax	12	19	24	14	18	22	30	47
Others	18	19	6	6	—	—	—	—
Total	2068	2077	2206	2573	2897	2954	3057	3088

Source: Data based on Economic Survey 1998/99, Ministry of Finance, His Majesty's Government of Nepal, Kathmandu, and calculated by using consumer price index.

Guiding Principles of Domestic Indirect Tax Reform

In recent years, many governments have rationalized domestic indirect taxes. Since these taxes play an important role in low- and middle-income countries, they have become the focal point of tax reform programs. The current emphasis is on making these taxes broad-based, economically neutral, transparent, and easy to administer. To this end, many countries have introduced a VAT to replace other forms of distortionary turnover, excise, and sales taxes. For example, in 1977 Korea introduced VAT in place of eight different taxes in order to simplify the indirect tax system and its administration, to promote exports and capital formation, and to preserve the neutrality of indirect taxes.¹ Similarly, a series of low-income countries—including Bangladesh, Pakistan, Magnolia, Papua New Guinea, Western Samoa, Fiji, Madagascar, Ghana, Zambia, and Uganda—introduced VAT to replace other distortionary types of domestic indirect taxes.²

In most, if not all, countries the base of VAT is broader than that of the taxes it replaced. Several exemptions, special provisions, and the like, adopted under other forms of domestic

indirect taxes, were discontinued when the VAT was introduced. Similarly, VAT has often been extended all the way to the retail level. It has been introduced with either a single rate or fewer rates than those of the taxes it replaced. For example, out of the sixteen Asian countries using VAT, twelve countries have adopted a single VAT rate.

The design of VAT is able to accommodate many of the characteristics of the economies of low- and medium-income countries. In these countries, because of administrative reasons, large parts of the economy may prove to be impossible to tax while at the same time the modern sector may be excessively taxed. Through its credit mechanism, the VAT levies a tax when it is administratively feasible to do so while at the same time preventing the tax from cascading. As the economy expands and new goods and services are introduced, the VAT will naturally bring these activities into the tax system.

Nepal has followed the general world trend in the field of domestic indirect taxation. In the 1990s, Nepal completely revamped its domestic indirect tax system. The first set of reforms, which began in 1993, had the objective of eventually leading to the adoption of a VAT. By 1996, several reform steps had transformed the former system of excise duties on sixty-two goods, a sales tax with five rates, and several minor service-based taxes into one consisting of a sales tax with only one rate, complemented by a set of excise duties on ten items (fourteen items in 1998) and a few other minor taxes. The reform of the excise and sales tax systems prior to the introduction of the VAT was an innovative way to prepare the policy environment and the tax administration for the introduction of a modern VAT. Without these reforms, the chances for the successful implementation of the VAT would have been greatly reduced. After the reform of the excise and sales tax systems and about three years of preparation of the new tax system, its administration, and the taxpayers, the government finally implemented a modern VAT system on November 16, 1997. The VAT has one rate of ten percent and a zero rate for exports. The aim of the reform process was to establish a broad-based, simple, and transparent domestic indirect tax system that would help provide an elastic source of government revenue.

Domestic Indirect Tax Reform in Nepal in the 1990s

In 1990, Nepal's domestic indirect tax system was typical of low-income countries that are not major exporters of natural resources products, and whose tax and customs administration are weak. At that time Nepal levied eight different domestic indirect taxes: excises, sales tax, hotel, entertainment, air flight, contract, vehicle, and video and television taxes.³ The major developments introduced in the domestic indirect tax system in the 1990s are outlined below.

Excises

Policy

As in many low-income countries, excise duties have been the oldest source of tax revenue in Nepal. In recent years these duties have undergone considerable changes in terms of their coverage, rates, operation, and even relative importance. In 1990/91, excises were levied on fifty-five types domestically produced goods. In 1991/92, the excises were extended to another seven items. The bulk of revenue, however, came mainly from a few traditional items, namely alcoholic beverages and tobacco products. In reforming the excise tax system, the government began by taking off the excise tariff on relatively unproductive items. This process was accelerated in 1993/94 when excise taxes on thirty-two items were abolished. Excises on another eleven items were abolished in 1994/95; currently excise taxes are levied on fourteen items only.

In 1990/91, the rate structure of excises was very complicated. Excise rates were levied on a specific basis on certain items and on an *ad valorem* basis on others. In addition, on some items rates were fixed both on a specific and on an *ad valorem* basis, and the effective rate was the higher of the two. There was also a practice of levying both specific and *ad valorem* rates on some other excisable items.

Consequently, attempts were made to rationalize the rate structure of excise tax. Specific rates were integrated into *ad valorem* rates and the practice of fixing rates on both specific and *ad valorem* bases and effectively applying the higher of the two was discontinued. Now excise

rates on most items (with the exception of only a few, on which rates are fixed on an *ad valorem* basis) are fixed mainly on a specific basis.

Administration

Historically, excises in Nepal were collected under a physical control system.⁴ Under this system, an excise inspector was posted in each factory to keep control of the production and sale of excisable goods. A manufacturer of excisable commodities is required to complete the following formalities for the purpose of excises:

- Obtain a license
- Renew the license annually
- Obtain permission for the commencement of manufacturing from the excise officer concerned
- Keep raw materials, semi-processed, and manufactured goods under the supervision of the excise inspector
- Obtain prior approval from the excise inspector and pay the excise duties before removing the goods from factory premises

However, the physical control system (which still continues at present) has not only been ineffective in achieving its intended objectives (i.e., raising revenue while maintaining control of the production and sale of excisable goods), but has also proven expensive for both government and manufacturers. The government has to post inspectors in factories, while manufacturers are required to provide accommodation for the excise inspectors. In addition, it is inconvenient for manufacturers to continuously have to pay money to obtain routine approvals from excise inspectors. Finally, the collusion between manufacturers and excise officials often leads to revenue loss.

Sales Tax

Policy

Just like the excise duties system, the sales tax also had undergone considerable changes in terms of its nature, scope, and rates in recent years. In 1990/91, the sales tax was levied with five different rates—of 5, 10, 15, 20, and 40 percent—depending on the nature of commodities (the 40 percent rate was levied on alcohol, including beer). In 1993/94, the number of sales tax rates was reduced to two—10 and 20 percent—and this structure continued until 1995/96. In 1996/97, a uniform rate of 15 percent was introduced. In 1997/98, prior to the introduction of VAT, the sales tax rate was reduced to 10 percent for a while, but the imports by non-registered sales tax importers were still subject to the higher rate of 20 percent.

Administration

The administrative procedures of the sales tax had been heavily influenced by those of the excise system. This excise tax “philosophy” of the administration, with emphasis placed on physical controls, notional (approved) prices, and collusion between the taxpayer and tax officer, has been a crucial obstacle to modernizing the administration of all the tax systems in Nepal.

In 1990/91, the sales tax was levied only at the point of import or manufacture and on both imports and domestic products. In the case of imports, the sales tax was collected at import points. The base of the sales tax on imports was the sum of the import value, and the amount of import and countervailing duties (if any).

In the case of domestic products, the sales tax was levied on the sales of manufacturers, with the base being the sum of the ex-factory price and excises, if any. For the purposes of this tax, manufacturers—other than cottage industries—were required to register and renew their sales tax registration annually. Since the sales tax was influenced by the legacy of excise duties, the sales-tax-registered manufacturers were required to complete several formalities. For example, since the sales tax was to be levied on the actual sales price, the approval of prices by the sales tax authorities should not have been required. In practice, however, sales-tax-registered

manufacturers had to either get the approval of the sales tax administration for their prices, or publish these prices in the newspapers. Under this system it was also mandatory that the sales tax authorities stamp invoices. Sales-tax-registered manufacturers also had to submit the details of their inventory, sales, etc., every month to the sales tax office, as well as copies of all invoices together with the monthly tax return. In addition, they were required to submit an annual return form and have a final annual assessment made by the sales tax officials. A taxpayer needed the signature of the tax officer on a voucher before he could pay the tax to the bank.

Sales-tax-registered manufacturers were also required to pay an advance sales tax on the import/local purchase of their raw materials, auxiliary raw materials, and chemicals. This advance tax was credited against the tax on output. However, manufacturers were not allowed to offset the tax paid on other inputs like telephone services, stationary, furniture, and equipment. Thus, sales-tax-registered manufacturers used to get only a partial credit for the input taxes they paid.⁵

Minor Domestic Indirect Taxes

Minor domestic trade taxes may include air flight, entertainment, contract, health, hotel, and vehicle taxes, as well as highway improvement fees and liquor control service charges. Of these taxes, VAT replaced the hotel, contract, and entertainment ones. The government has also been considering integrating the vehicle tax with the local level vehicle tax (and thus levying it only at the local level), as well as handing over the air flight tax to the Civil Aviation Authority. Also, since there is no justification for the liquor control service charge, it should be abolished. These measures, if implemented, will allow the tax administration to concentrate on more elastic and important taxes.

Adoption of VAT

In Nepal the VAT replaced the import/manufacturing level sales tax, as well as the hotel, contract, and entertainment taxes. This section highlights the rationale for the VAT in Nepal, points out tax policy considerations that were important in the design of Nepalese VAT system,

and describes the VAT preparatory and implementation processes.

Rationale for the VAT in Low-Income Countries

Nepal is typical of many low-income developing countries. Agriculture still occupies a dominant role in the Nepalese economy. The organized sector is very small and channels of distribution are few and not well demarcated. Accounting standards are poor in the trade sector. Many wholesalers and retailers may not come under the VAT net immediately. So initially the VAT base might not be very different from that of the sales tax system. But VAT will improve with the situation over time; as businesses get bigger, they will fall under the VAT net (which was not the case under the import/manufacturing level sales tax). Since VAT allows taxpayers to claim an input tax credit, there is no need to levy tax on tax and/or to apply a markup on VAT paid on inputs of taxable sales. This means that the VAT can be applied anywhere in the economy without leading to cascading/pyramiding because it employs a credit mechanism. Further, exports are zero-rated under the VAT system. This means that while exporters are not required to pay any tax on their exports, they are still entitled to claim VAT paid on the inputs of exports. Thus VAT relieves exports from the burden of taxation through the zero rating of exports. Since VAT is an account/transaction-based tax, there is no need for physical control or approval of prices by the tax authorities. It will help break the tax administration's pattern of excise tax philosophy based on physical control—which is an impediment to the unrestricted functioning of businesses. The implementation of a VAT in Nepal will help establish an account-based tax system that will ensure transparency.

Broaden the Tax Base

At present, the share of the total economy in Nepal that flows through market channels—where indirect taxes can be administratively levied—is relatively small. The potential tax base for all indirect tax systems is at best less than 25 percent of gross national expenditure (GNE).⁶ The potential tax base becomes even smaller when domestic trade taxes are collected at an early stage in the production and distribution process. Furthermore the large number of exemptions granted on sociopolitical grounds and a weak tax administration only aggravate the problem.

The base of the import/manufacturing point sales tax was small because of practical and administrative reasons, and hence the agriculture and service sectors were almost entirely kept out of the scope of the sales tax. Cottage industries were also exempt from the sales tax, and so were a large number of items, including most foodstuffs, drugs, medical equipment, and some educational materials. The government frequently granted exemptions for particular products, persons, or organizations through gazette notification. Furthermore, the base of the sales tax was legally narrow since it did not include the value added at the wholesale and retail levels.

The narrow tax base had been further eroded due to compliance weaknesses that were tolerated both through the understatement of import value/ex-factory price and/or through smuggling. The import duties and the sales tax on imports were collected at the same time, by customs along with countervailing duties and an advance income tax. Hence, the total effective tax burden at the import point could be very high, providing an incentive for the understatement of the true value of the tax base or outright smuggling. Since the sales tax was not levied at a stage beyond the import/manufacturing point, there was no possibility of capturing the evaded tax at a point further down the trade channels.

In order for the tax base to be stable over time, it is necessary to limit exemptions and to bring some of the value added at the wholesale and retail level into the tax net. To do this, it is desirable to introduce a VAT system using the credit/invoice type of administration. Such a tax system will gradually bring the value added at the wholesale and retail levels under the tax net as the size of the establishments increase over time, and will reduce the incentive to understate import value/ex-factory prices. This is because under the VAT an understatement of taxable value at the import/manufacturing point would be corrected on subsequent levels if distributors are subject to tax, since the credit for taxes paid on purchases would be correspondingly lower. Over time, as more of the economy enters the formal market economy, the VAT system of administration will automatically broaden the tax base.

Nepal currently generates more than one-third of its tax revenue from taxes on international trade. The relative position of these taxes will decline in the Nepalese tax structure due to the trade reforms taking place in the region, particularly in India. Furthermore, Nepal will

not be able to levy import duties on trade that takes place within the South Asian Association for Regional Conference (SAARC) region after the implementation of the South Asian Free Trade Agreement (SAFTA). As a consequence, Nepal will have to become less dependent on international trade taxes for its revenue, which is also desirable for resource allocation reasons. Hence for revenue purposes a VAT system is needed as an alternative to import tariffs. At the same time, the VAT system promotes a flow of information to (and between) other tax systems, particularly the trade taxes system since customs information is required to determine the validity of input tax credits claimed. The VAT could not only be an effective instrument to generate substantial revenue at customs points, but could also help streamline tax policy in general. The VAT also has a natural link with the income tax. Currently, the main basis for the income tax assessment in the case of importers is the information supplied by the customs. But only a fraction of such information reaches the tax administration. The administration of a VAT system could provide the information on imports, local sales, and input costs that can be used to assist in the effective implementation of the income tax.

Even though the base of VAT may not be very broad initially (compared to the Organization for Economic Co-operation and Development [OECD] standards), such a system is nevertheless desirable for low-income countries like Nepal. It collects revenue on some inputs for goods and services even if the latter are not taxed at some stages in the distribution process. The VAT can be collected at points where tax collection is feasible without fear of causing the cascading since it can be applied as a credit or refunded at later stage of trade if it becomes again subject to taxation.

VAT and Tax Neutrality

Incentive to Restructure Business to Avoid Taxation

An import/manufacturing level sales tax encourages manufacturers to transfer some of their activities (like packaging and transportation) to the wholesale stage in order to lower their overall tax liability. It also encourages manufacturers to establish artificial sales depots in order to reduce the tax base. For example, some manufacturers might appoint their family members or relatives as dealers, sell them goods at artificially low prices, pay less taxes, increase the dealers' margin and reap much of the profit indirectly from family members. Under these circumstances the firms that are not involved in transferring (or are unable to transfer) some of their functions to dealers will be subject to a higher effective tax rate than those who are cheating. Such a sales tax is also not neutral since its effective tax rate varies from commodity to commodity.

The VAT, however, when it extends all the way to the retail level, does not induce taxpayers to make changes in their methods of doing business simply to avoid paying tax. The reason for this is that the tax liability on a given commodity depends on the total value added regardless of the number of stages through which it has passed. Hence the tax does not encourage taxpayers to transfer some of their functions to their wholesale dealers since the latter are also subject to VAT.

Tax Cascading/Pyramiding

An import/manufacturing level sales tax also suffers from the problem of tax cascading. For example, in theory, the goods produced by a domestic industry, with domestic raw materials and used by another domestic industry as inputs, were exempt from sales tax/excises (at the recommendation of the department concerned). However, this rarely happened in practice due to administrative complications. The end result was that excise/sales taxes were levied on inputs that had already been taxed without allowing any credit for the taxes previously paid. In the best of cases, taxpayers received partial tax credit, that is, they were allowed to deduct from the output tax the input tax paid on raw materials, auxiliary raw materials, and packaging materials (but not the tax paid on telephone bills, office furniture, vehicle, fuels, stationery, and other services used in their business). This means that there was scope for levying taxes upon other

taxes, resulting in a cascading effect with a tax-induced rise in the price that was higher than the tax amount.

Since credits, under the VAT, are given for all taxes paid on inputs, cascading is either eliminated or at least greatly reduced. Moreover, the VAT is neutral with respect to investment decisions⁷ since a credit is given for taxes paid on investment.

Relative Tax Burden of Domestically Produced Goods and Imported Goods

The import/manufacturing level sales tax discriminated against domestic products *vis-à-vis* imports because the trade margin of the domestic manufacturers who carried out wholesale functions was included under the tax base, but the trade margin of the importers who conducted similar functions for imported goods was not. In addition, there was a chronic under-valuation of imports. This means that even though the nominal tax rate was the same for both types of goods, the effective rate of import/manufacturing level sales tax was higher on domestically produced goods than on imports.

A VAT system puts imports and domestic products on equal footing, since the burden of this tax depends upon only the final price, irrespective of the proportions of value added reported at different stages in the process of import/production and distribution.

Taxation of Exports

An import/manufacturing level sales tax was also not attractive from the point of view of foreign trade. Under this system, export-oriented industries were allowed to import or purchase raw materials up to an amount certified by the Department of Industry or the Department of Rural and Cottage Industry through a bank guarantee. This guarantee was equivalent to the amount of excises and sales tax payable on such items. The bank guarantee was released after the submission of the proof of the export or sale of goods in convertible foreign currencies, which were produced using such raw materials.⁸ Unfortunately, bank guarantees in Nepal are both expensive and bureaucratically difficult to administer.

Furthermore, the legal provisions for the refund of the taxes levied on the inputs for

exports have not been implemented due to the lack of simple, well-functioning duty drawback and excise refund systems. Also, cascading and pyramiding effects make it difficult to refund the exact amount of taxes levied on the inputs used for exports. All these factors make the domestic products less competitive in international markets.

Provided that there exists an effective refund system for issuing refunds of excess credits on exports, the VAT system should improve the efficiency and competitiveness of domestic products on international markets by relieving exports from the burden of taxation through zero-rating them. The statement of taxes paid (on invoices) and the absence of tax pyramiding/cascading effects would make it possible to refund to exporters the exact amount of the tax paid on the inputs contributing to exports. However, even under this system a bureaucratic problem still remains, namely that of implementing a system of paying the input tax credit refunds to exporters in an efficient and fraud-free manner.

Establishing an Account-Based System of Taxation

Prima facie, the import/manufacturing level sales tax was easy to administer since it was collected at a few border points and one international airport (in the case of imports) and through about two thousand manufacturers (in the case of domestic products). However, the sales tax was unnecessarily complicated, being levied not on the actual selling prices but on notional sale values, which included the ex-factory price/import value and the amount of excises/import duties. Hence, determining the tax base was complicated by problems associated with defining the base of excises or import duties. Additionally, sales-tax-registered manufacturers of domestic products were required to get their prices approved by tax officials. In the case of excisable items, the manufacturers had to get not only their ex-factory prices approved by the excise authorities, but their dealer, wholesale, and retail level prices as well. Consequently, collusion or harassment in the price negotiations between tax officials and taxpayers were very likely to occur. Since administrative capabilities to determine the taxable value in a realistic way were lacking, prices were usually fixed arbitrarily. Taxpayers also complained that tax officials gave their approval to raise prices but not to reduce them. As a result, manufacturers paid taxes on previously determined high prices even if the actual prices had meanwhile fallen due to reductions in the prices of raw materials or other market conditions. Furthermore, as earlier

stated, manufacturers had to go through several tax formalities, starting with registration and ending with the actual payment of the tax.

Furthermore, since for the mandatory registration under the sales tax system no threshold was ever fixed, some small manufacturers⁹ found themselves under the tax net. However, this created a two-fold problem: On one hand, it was very difficult to effectively control all these manufacturers, while on the other hand the small manufacturers found it difficult to comply with the tax rules.

In addition to sales tax, there were other taxes (the hotel, entertainment, and contract taxes) that were paid only by a limited number of taxpayers in various capacities. Hence, the tax officials had to deal with the same taxpayer several times, but in connection with different taxes. These different sets of taxes lead to a “complex and multiple relationships between traders and government,”¹⁰ considerably increased both the administrative and the compliance costs, and were an impediment to the free functioning of businesses.

Since the VAT replaced the sales, contract, entertainment, and hotel taxes, it allowed the tax administration to concentrate on a single tax with a single rate and few exemptions. Since taxpayers also had to go through fewer formalities, the difficulties facing both parties were greatly reduced. Also, since VAT is levied on the actual selling price, it avoids the problem associated with the negotiation of taxable value. Moreover, small vendors are not required to register for VAT purposes if their annual turnover is below the registration threshold level.

VAT, however, requires more effort from those businesses (mainly traders) that were not registered for any of the taxes replaced by the VAT. These vendors, however, are relatively big and will not find it very difficult to comply with VAT formalities since they are accustomed to more complicated accounts maintained for income tax purposes. The Finance Act of 1997 stipulated that the purchase and sales figures submitted for VAT purposes can be used for income tax purposes as well. This will greatly improve the current situation in which most taxpayers complain that the income tax officials do not accept the books of accounts they maintain. VAT will help develop of a system of invoices, which will be useful for a number of purposes. Although many vendors will have to go through the VAT formalities this tax will

enhance the transparency of the tax system by eliminating the existing uncertainties, negotiations, and subjective judgments.

Also, since the VAT is a new system of tax administration, it might help to break the excise tax approach (based on physical control) to tax administration. In the future, the VAT should result in fewer tax rate changes and exemptions of particular goods or services, thus improving the domestic indirect tax system over time.

VAT Design for Low-Income Countries

In the development of the VAT a number of policy issues had to be decided so that the particular design of Nepal's legislation could better suit the country's problems and needs. The basic philosophy behind the formulation of the VAT system was to establish a simple, transparent, and broad-based tax system, based on the principle of self-assessment, and to eliminate all sales tax formalities influenced by the traditional excise tax mentality. Since Nepal has an economic structure typical of low-income countries, it necessitates a VAT system design that is somewhat different from those in more advanced European countries. Since the potential VAT base is very small as a share of gross domestic expenditure, exemptions and zero-rating, except for the most necessary situations, should be generally avoided. Furthermore, because VAT is only effectively applied to relatively few transactions, it should be as simple as possible: it should have only one tax rate (in addition to the zero-rating of exports), and use exemptions rather than zero-rating whenever relief from VAT is necessary.

Type of VAT

The selection of an appropriate type of VAT is crucial in the formulation of a viable VAT system. There are three possible VAT options: consumption, income, and gross domestic product types. Since, in terms of economic efficiency, using consumption as a base for VAT provides the least distortion, Nepal decided to adopt the consumption-type VAT. Under this type of VAT, investment is relieved from the burden of taxation since taxpayers receive immediate credits or refunds for the taxes paid on capital goods. Hence, the consumption-based VAT does not distort the allocation of labor and capital in production. This type is attractive for foreign trade

considerations, since it only taxes tradable goods once (i.e., upon being imported). The consumption-based VAT does not create an incentive to classify capital goods as non-capital goods, nor does it require the taxpayer to calculate depreciation expenses as the income-type VAT would.¹¹

In practice, investment may not be completely relieved from the burden of VAT in a low-income developing country like Nepal. The effective tax rate on investment is not going to be zero because of the six-month carry-forward provisions of the excess credit¹² and the likelihood that it may not be refunded in a timely and efficient manner. Furthermore, since some capital goods are closely tied to both business and consumption, it will be difficult to determine if the input credit should be given. Hence if the system is administered too generously or too strictly, either abuses of the tax credit refund mechanism (leading to revenue loss), or, respectively, capital goods taxation may occur. Also, since it is impossible to monitor asset-use changes, only 40 percent of the total input tax in the case of vehicles and airplanes, 60 percent in that of computers, and none at all in the case of petrol is allowed as a tax credit. But this implies that the tax is not purely consumption-based; in reality, the Nepalese VAT has elements of both the consumption and the gross product VAT types, at least in the short-run. Over time, however, when practice will become closer to theory, the Nepalese VAT will also move closer to a true consumption-type VAT.

Methods of Tax Computation

In the design of VAT, there are three options for tax computation: addition, subtraction, and tax credit methods. Since the addition method—under which the tax base is the sum of the remuneration of the factors of production (i.e., the total of wages, interest, rents, and profits) is very complicated account-wise, it is hardly used in practice. So the real choice is between the subtraction method, which deducts purchases from sales, and the tax credit method, which deducts input taxes paid from output taxes collected.

The subtraction method is a crude way of computing VAT and may be appropriate for taxing only small vendors; if the VAT was levied with multiple rates, bookkeeping requirements would

be avoided. Since Nepal adopted a single VAT rate, it was not necessary to make such a special provision for small vendors, especially since it was thought that the subtraction method would face problems in identifying taxable and tax exempt items (due to Nepal's large number of exemptions).

The tax credit method requires less accounting since it only records the purchase and sales invoices, and since value added is never calculated but rather obtained indirectly by deducting input taxes from output ones.

Since invoices give the tax administrator an opportunity for cross-checking, the tax credit method promotes better record-keeping than the other two methods. The amount of VAT paid needs to be explicitly identified on the invoices. Since the system is invoice-driven, the purchaser has an interest to demand a correct invoice of all purchases so as to claim the input tax credit. In a country where invoice issuing and proper accounting systems are lacking, such a system has the advantage of promoting transparency in taxation and modern business practices. However, the invoice method is attractive for other reasons as well:

- It works well with the consumption-type VAT.
- It is simple, since taxpayers do not have to calculate value added; hence, tax officials do not have to check these calculations.
- It allows, if needed, the fixing of lower rates at early stages in the process of production and distribution (for instance on raw materials), without causing an overall revenue loss due to the catch-up effect.
- It is attractive for foreign trade considerations, since the taxes paid on the inputs for exports can be exactly refunded.

Tax Credit Mechanism

Under the tax credit method, a taxpayer is allowed to deduct all taxes paid (and payable) from all taxes collected (and collectible) in the respective reporting period. In general, VAT is applied on an accrual basis; the tax credit is given when goods are bought and is not connected with the payment of the tax. However, in the case of small taxpayers some countries adopt a cash

method. Under such a system, taxpayers do not have to pay taxes on their credit sales until after they receive the money. No such mechanism was adopted in Nepal.

Under the sales tax system, credit was tied to the physical use of inputs. Such a system, however, makes tax administration too complex. Consequently, under the VAT, the tax calculation is made per tax period on a global basis rather than on an item-by-item or day-to-day basis. The tax period can be one, two, or three months (or even more or less for certain types of taxpayers), depending upon the revenue requirements, accounting standards, number of taxpayers, work load of the tax administration, the need for refund, and so on. A monthly tax period (a trimester for voluntary registrants) was recommended for Nepal. Tax credits are allowed in the taxes paid on the purchase of all inputs used to produce or sell taxable items, irrespective of their use, but on condition that it is taken within one year of the issuing of the tax invoice. Under such a system, purchase and sale figures must be audited periodically to avoid an overstatement of the tax credit claimed by enterprises.

VAT Coverage in Terms of Stages of Production and Distribution

Theoretically, a VAT is levied at all stages in the production and distribution process. Sometimes, however, it is limited to certain levels only, as was, for instance, the case in Indonesia and Bangladesh, who started with a manufacturing level VAT. In Nepal, as well, there were requests, particularly from the business community, to limit VAT to the manufacturing/wholesale level. As stated earlier, Nepal had already implemented a VAT-like sales tax at the manufacturing level and had tried to implement a two-tiered sales tax system in the case of a few commodities, which was supposed to operate like a VAT up to the wholesale point. But the business community strongly demanded the abolition of this tax in light of the preparation for a full-fledged VAT.

On administrative grounds, however, it is hard to justify the exclusion/inclusion of vendors from/in the tax net on the basis of their place in the production and distribution channel.

For instance, it is not at all clear why a small vendor at the manufacturing level should be brought under the tax net, while a big vendor at the retail level shouldn't. The size of business is more important than the place of vendor in the production and distribution chain; as stated elsewhere, the exclusion of small vendors is justified on administrative, efficiency, revenue, and compliance grounds. Hence keeping small vendors out of the VAT net by fixing a high threshold is preferable to levying VAT only at some stages. That is why Nepal adopted a VAT extending all the way to the retail level, as well as a policy of keeping small vendors out of the tax net by means of a size threshold.

VAT has a huge advantage in that this tax can be levied on the inputs used at a certain stage in manufacturing or distribution even if the sale at that stage is exempt from tax due to the threshold! Most of the value added is at earlier stage(s). Thus, even if retailers are exempt from tax due to the threshold, some tax is nevertheless collected on their inputs. Slowly, as business establishments get larger, VAT creeps in the economy. As development takes place, total turnover gets higher, the tax base grows and retailers come under the tax net due to the input tax credit provision. The difference between registered and unregistered vendors will gradually decrease over time, but in the immediate future very few vendors will be subject to tax at the retail stage.

Geographical Coverage

There was a special debate in Nepal regarding the application in the VAT in remote areas where the prices are much higher than in cities due to the high transportation costs. The inclusion of the remote areas in the VAT net would result in the rural residents paying more tax than the urban consumers on similar goods and supplies. To address this situation four options were suggested:

- (i) The exclusion of remote area from the VAT net

Since it is not easy to identify remote areas, this has to be largely an arbitrary decision. Even if some criteria would be developed to identify areas to be excluded from VAT, it would still be necessary to periodically revise the list of excluded areas. Furthermore, this might induce taxpayers to set their sales offices or business addresses

in the excluded remote areas so as to avoid paying tax.

(ii) Fixing a higher threshold for remote areas

Even if in the remote areas a higher threshold is fixed, it will still be necessary to register the vendors (if any), that have an annual turnover above the threshold. However, it is not practical to set up an office to administer only a few taxpayers in the remote areas.

(iii) Fixing lower rates for such areas

Fixing lower rates for remote areas is not going to solve the problem either. The reason is that there are hardly any taxpayers in the remote areas, and hence establishing VAT offices there to collect nominal revenue (generated through lower rates) is not justified on administrative grounds.

(iv) No effective enforcement of VAT law in this area

The best way to handle the problem is not to enforce VAT regulations effectively in those areas. The bulk of trade in the remote areas consists of agricultural products, of which many are either directly exempted from VAT, being basic foods, or use-exempted inputs. The taxpayers who conduct large taxable transactions will be registered for VAT and controlled by VAT offices located in the nearest areas. The VAT offices will be set up in those areas and law will be enforced more effectively once businesses grow due to increased transportation facilities and the development of economic activities.

Rate

It is very important to adopt an appropriate policy in setting VAT rate(s). There are two basic issues involved: one is the number of VAT rates, and the other is the level of the respective VAT rates. Some countries have applied a single VAT rate, while others have experimented with multiple rates. While a single VAT rate has been criticized on equity grounds, multiple rates have many disadvantages:

- Multiple rates break down the neutrality of the VAT since resources are diverted from highly taxed to more lightly taxed areas.
- Multiple rates complicate the tax system, since goods need to be classified according to rates (which is not easy to do).
- Taxpayers have to keep separate records of the purchases and sales made at different rates, and tax officials should check them.
- Multiple rates induce lobbying for lower rates for certain goods or services.
- Multiple rates offer a scope for tax evasion since taxpayers can classify higher rated goods as lower rated ones on sales, and vice-versa for claiming tax credits.
- Some vendors may not apply the proper rates, hence discriminating among competing suppliers.

Because of the disadvantages of multiple rates, there is a worldwide tendency to impose a single rate, and the countries that have previously adopted multiple rates have tried to move toward a more uniform rate structure. Nepal adopted a single rate policy from the very beginning of the preparation for VAT. To this end, attempts were also made to move toward a uniform rate of the sales tax: the number of sales tax rates was reduced gradually and was finally unified in 1996/97 (prior to the introduction of VAT).

The reason for the adoption of a single positive rate was to make the VAT system simple for both taxpayers (by making bookkeeping, invoicing, and return requirement easier) and tax administrators. Also, a single rate reduces the scope for tax evasion and hence saves the time tax officers would be spending on checking records for this purpose. Moreover, a single VAT rate does not induce producers and consumers to choose lower-rated goods over higher-rated ones and may even bring about a lowering of the overall rate—which would be desirable from both economic and administrative efficiency points of view.

A study carried out to find an appropriate rate of VAT¹³ recommended a 14 percent rate to make the VAT system revenue neutral and hence to ensure its smooth implementation. However, it is

better to start with a higher rate and gradually lower it, once its revenue potential is realized. The authors of this study recommended that a 15 percent rate would be a good choice, a rate that would prevent any revenue loss. The authors state that “there always exist a number of revenue risks that accompany the introduction of a new tax system. The tax administration in Nepal is not as experienced or trained, as it would be desirable. Hence, some slippage in tax compliance may arise during the first year of the VAT implementation. Therefore, it would have been prudent to introduce the tax with a higher rate of 15 percent to reduce the risk of revenue shortfall.”¹⁴ This rate would have actually put an easier burden on the taxpayers than the 15 percent sales tax rate since the taxpayers *receive* full input tax credit under the VAT. However, in July 1997, through the Finance Act of 1998, the government decided to reduce the sales tax rate from 15 percent to 10 percent. However, the rate of sales tax for the imports by non-registered importers was fixed at 20 percent. These rates remained unchanged under the VAT as well until July 10, 1998, when a single rate of VAT (of 10 percent) was adopted.

Exemptions

Theoretically, VAT can be levied on all goods and services. However, in practice some goods and services are exempt for three main reasons: administrative (some goods and services, like financial institutions, are too hard to tax); political, social, and philanthropic (some relief is given to charities and to medical and educational goods and services; and excess credit (some goods and services are exempt to minimize the excess credit and refund problem). The design of the Nepalese VAT system has taken into account all these reasons (as well as several others) in devising the exemption list. Some of these reasons are summarized below.

- (a) Administrative: Unprocessed food is exempt, although food (including green vegetables and fresh fruit) served in restaurants, hotels, cafes, and similar establishments is, by definition, considered processed. Also exempt are fresh vegetables, fresh fruits, and financial and insurance services.
- (b) Political, social, philanthropic, and merit goods: Because of their perceived beneficial effects,¹⁵ the government wishes to encourage the consumption of merit goods like school books, daily newspapers, and public transportation. Since it is difficult to identify schoolbooks, it was decided to exempt all sorts of books, magazine, and newspapers. Medical and educational services are also exempted.

However, these sectors constitute a large part of the modern formal economy and hence are easier to tax than much of the informal sector; so instead of zero rating them, they are exempted, which permits the collection of some tax on their inputs. The taxation of transportation services was also debated; at first VAT was levied on both the transportation of goods and the long-distance transport of passengers, but in the light of mounting opposition both were later exempted. The tax on electricity was seriously considered, but since the government had increased the electricity rates significantly around the time when the VAT system was being designed, electricity was exempted from VAT, at least in the immediate future.

- (c) Excess credits: Exempting certain imports/purchases of inputs and closely monitoring them is preferable to a refund or duty draw-back system, which aids in collusion between taxpayers and tax officials. So some goods are exempted to avoid the problem of excess credit. For example, raw wool is the main input for carpets—Nepal's major export. Many small producers are involved at different stages (including import, carding, dying, weaving, washing, and export) in the production of carpets. Furthermore the domestic consumption of carpets and handicrafts is very small.

Exemptions, however, are not desirable for several reasons, some of which are outlined below:

- Resources are diverted from taxed to exempted areas, resulting in economic inefficiency.
- The need to classify exempted goods results in administrative complexity and undue pressure from influential groups to exempt their goods.
- The burden on both taxpayers and tax administrators is increased, since the former has to keep separate records of taxed and exempted commodities and the latter has to check them.
- Exemptions create loopholes for tax evasion since taxed goods may be classified as exempted ones.
- Cross-checking of invoices used to claim input tax credit becomes less feasible.
- Exemptions reduce the tax base, and hence result in higher rates levied on

taxed goods.

Because of these reasons, a policy was originally adopted to keep exemptions to a minimum. However, over time, due to pressure from various influential groups, the exemption list was expanded.

Zero Rating versus Exemption

If the objective is to completely relieve certain commodities/transactions/persons from taxation, a zero-rating policy may be adopted. Such a policy, however, is more complicated than an exemption-based one. Under the zero-rating system, vendors have to register, keep records, and file returns, while VAT officials not only have to check these returns and records but also be more careful in order “to prevent fraudulent request for refunds.”¹⁶ John Due explains that a zero-rating system “will also require registration even of firms handling only zero-rated sales. It is, therefore, desirable to keep the scope of zero-rating very limited, preferable only to exports. VAT would not apply to the exports concerned but exports would receive input tax credit, meaning that exports would be free from tax. If it is difficult to administer VAT on certain goods, persons, or transactions it is better to provide exemption and collect some revenue from inputs. Exemption is clearly preferable when for various reasons it is desirable to tax the sale of the commodity, but the purchasing firms cannot effectively be taxed on their sales (small firms, for example).”¹⁷

In Nepal, exports are zero-rated in order to maintain the competitiveness of Nepalese products on international markets. The VAT will encourage exporters to come under the official trade regime due to the refund mechanism. Under the sales tax system any sales made in convertible foreign currency, even in the local market, were deemed to be exports and hence were exempted from the VAT. However, the tourist spending in convertible foreign currency on hotel accommodation, restaurant meals, and tours was taxed. Under the VAT, all these sales on consumption in Nepal are taxed. The goods purchased by tourists are, of course, often not consumed in Nepal and are also not zero-rated. To make the tax system simple, the use of the zero-rating policy has been limited. In general, an exemption-based policy is less demanding than a zero-rating one, but sometimes it faces administrative problems because of the need to

apportion the input tax credits for both taxpayers and tax collectors. Consequently, attempts were made to keep both exemptions and zero-rating policies at a minimum.

Treatment of Special Sectors, Organizations and Transactions

Agriculture

It is difficult to levy VAT on agriculture due to both administrative and political reasons. That is why in many countries agriculture is given special treatment under a VAT system. Some countries directly exempt the agricultural sector or zero-rate agricultural products, while others allow deemed credits when agricultural products are processed. Nepal has exempted the agricultural sector's sales, which is perhaps easiest to implement administratively.

Financial and Insurance Services

A VAT on financial and insurance services is justified on both efficiency and equity grounds. As Tait says, "the financial sector in most countries is considered able to bear a tax, and where most services are taxed to exclude financial services seems both unfair and distortionary."¹⁸ However, it is difficult to define value added for these services and hence to tax them. The reason is that "for financial services and insurance (in particular life insurance), it is argued that the price at which those services are sold (i.e., usually in the form of the interest and premiums, respectively) is not necessarily a true reflection of the value of services being provided by the financier or insurer."¹⁹ For example, "interest includes elements which reflect the risk of the loan, the real cost of capital, the inflation rate, and a charge for the service rendered. In principle, only the last should be taxed, but in practice it is impossible to separate out this taxable component of interest from the rest. Because of this problem, no country subjects the full range of financial services to a VAT."²⁰ An OECD report states that "the insurance premium is made up of a transfer to a fund, which is then invested, on the saver's behalf, and a payment for the services involved in running that fund. It is felt by most countries that it is not possible to arbitrarily differentiate the premium into two payments, the contribution to be untaxed but the payment for the services to be taxed. The difficulty of doing so is compounded with life insurance, where there are in addition all the problems of financial services as well as those relating to insurance. Hence all countries exempt life insurance premiums from VAT."²¹ So the price paid for these services

cannot be used as the basis for VAT under a tax credit method, which obtains the net tax liability by imposing a tax on the sale price and by subtracting the taxes on inputs.²² Under these circumstances, the addition method seems to be a better alternative. It results, however, in a number of problems like the requirement of calculating profits, multiple taxation, and the difficulty of making accurate border tax adjustments.²³

Thus, since it is difficult to bring financial and insurance services under the VAT net, they are generally exempted.

As is the case for all less-developed countries, trying to impose a VAT on financial and insurance services in Nepal at this time is highly unpractical. Hence, this sector has been exempted from the VAT, which means that it will pay taxes on its inputs but not on its output.

Immovable Property

Rentals, leases, and sales of land and buildings attract special attention under a VAT system for several reasons. VAT is a tax on consumption; since land is not consumed, it should be kept out of the VAT net. Buildings, however, can be treated as consumer-durable (just like automobiles), which are subject to tax. Furthermore, unlike other goods and services, land and buildings are not frequently sold, and their transfer is commonly subject to separate taxes like registration fees, stamp duties, etc. Thus buildings and land rentals, leases, and sales are commonly exempted from VAT, although the construction of buildings is taxed.

Sales of buildings almost never occur in rural Nepal—where almost 90 percent of the population live. Each family has a separate house and, if it is needed, a new house is constructed rather than bought. Moreover, due to social and geographical factors in Nepal, this situation is likely to continue for several years. The selling of buildings is not common in urban areas either because of the very high land transfer tax. So a VAT levied on the sale of buildings does not seem promising in Nepal. Thus the sale, lease, and rental of both land and buildings are exempted under the VAT. Accommodation in hotels and similar sectors are brought under the VAT,

however, and so are the materials used for construction and repairs.

Government, Government Enterprises, and Local Authorities

In some countries goods and services such as transport, warehousing telecommunications, drinking water, radio, television, etc. are supplied by both the public and the private sectors. In such cases, for neutrality reasons, it is desirable to treat the supplies of governmental (and related) organizations on an equal footing with those of the private sector.

Local bodies may provide services like electricity, water, sanitation, drainage, as well as (admission to and use of) public utilities like car parking areas, public halls, swimming pools, stadiums, public transportation, educational facilities, and national parks. Their purchases and supplies are taxable since “the economic value of the particular activity does not depend on whether the supplier happens to be a private firm, a statutory board or a government department. Basing the tax on the nature of the activity rather than the identity of the supplier ensures a level playing field. Purchasers of government supplied goods should be neither advantaged nor disadvantaged by their choice of a government agency as the supplier.”²⁴ If governmental goods and services, which compete with their private sector counterparts, are exempted, they become artificially cheaper, leading to considerable distortions in the competitive process.

When they compete with private firms, the government, governmental enterprises, and local bodies in Nepal are treated as suppliers of goods and services in order to avoid distortions. In such cases, they are subject to the same VAT requirements faced by other taxable traders.

Charitable and Nonprofit Organizations

Since nonprofit organizations are involved taxable activities, there is no economic basis for excluding them from the tax base. If their supplies are automatically exempt from VAT, the result may be tax-induced changes in business activities, which would defeat neutrality. So if their supplies compete with commercial ones, because of both equity and efficiency reasons, it is necessary to tax them. Because of social reasons, a strong lobby formed to promote the exemption of charities from the VAT. Nevertheless, since it is not easy to distinguish between the pure charity work of nonprofit organizations and their business activities, it was decided not to exempt automatically their supplies from the VAT.

Small Vendors

Due to their large number, small vendors are difficult to monitor. Hence, their inclusion in the tax net would imply high compliance and administrative costs, without much revenue gain in return. For these reasons, as well as for political ones, small vendors are generally excluded from the VAT net.

Small vendors are defined as such on the basis of criteria such as turnover, value added, capital investment, number of employees, and number of business establishments. Of these criteria, turnover is the one most commonly used worldwide. Generally, the procedure is to fix a minimum level of turnover, known as the registration threshold, and grant to the vendors having an annual turnover below this threshold the option to register. Since value added may differ in different lines of business (even in those with similar sales threshold levels), low-income countries may set distinct thresholds for different types of taxpayers.

A threshold encourages vendors to artificially suppress their level of turnover just below the threshold, or to split up their businesses in order to remain outside of the VAT net. To discourage business splitting, the threshold may be applied to all the units of a vendor rather than to each unit separately. Alternatively, vendors having more than one firm should be considered large vendors irrespective of their turnover.

There is a rich world experience regarding the treatment of small vendors. Some of the special schemes designed include: allowing small vendors not to register, or subjecting them to simplified VAT requirements like simplified invoices; longer accounting, return, and payment periods; cash-basis accounting; lump sum annual taxes; surcharges; lower rate(s) on sales, higher rate(s) on purchases; deemed input tax credit; and separate low-rated turnover taxes. Special treatment, however, eliminates the neutrality of VAT.

Small vendors in Nepal are often illiterate, and do not maintain proper records. They are kept out of the tax net through the provision of a registration threshold. To keep the system simple, it was decided to have a single threshold (at Rs 3 million) and, if need be, to fine-tune it later, after some experience with this system had been gained.

Also to keep the system simple, Nepal adopted no special scheme for small vendors either. However, in order to encourage small vendors to come under the VAT net, those who registered voluntarily were granted a lengthened return period of four months (as opposed to one month, which was the norm) .

Administrative Procedures

Registration

Any person or organization involved in taxable activities is required to register. There is no provision for group or divisional registration; for instance, companies within a group are required to register separately for VAT purposes. VAT registered companies are required to levy VAT on inter-company transactions and fulfil all VAT requirements, which leads to an increase in both compliance and administrative costs, as well as to the possibility of tax cascading

Under a group registration system, related companies would be allowed to register as a single entity, and intra-group transactions would be disregarded for VAT purposes. This would reduce both the compliance and the administrative costs of VAT (by reducing the number of registrants), would eliminate the incentive to restructure, and would avoid the cascading effects of irrecoverable VAT when one group member sells exempted goods or services to another group member. For all these reasons, group registration should be also considered in the future.

Invoices and Bookkeeping

VAT is an invoice-driven tax and hence, for its effective implementation, the recording of the purchases and sales on each invoice is required. But in Nepal, the practice of issuing invoices and/or maintaining purchase and sales records has been very limited, at least for tax purposes. This fact was carefully considered when the invoicing and bookkeeping requirements of the Nepalese VAT system were being designed.

For VAT purposes, taxpayers are required to issue invoices of their sales and keep records of both purchases and sales. The original idea was to ask taxpayers to provide specified sale and

purchase information and not to issue invoices and maintain records in a specified manner. As such, the description of invoices, and purchases and sales books were included in the VAT regulations simply as an example. However, since according to the Ministry of Law and Justice anything included in the regulations is mandatory, taxpayers are now required to maintain purchase and sales books as specified in the regulations. However, with the prior approval of the VAT Department, taxpayers can issue invoices or maintain records differently.

Additionally, for small sales, taxpayers can use an abbreviated invoice on which it is not necessary to provide details about the buyer and to indicate VAT separately. However, due to revenue control reasons, the buyer is not be able to claim input tax credit on the basis of the abbreviated invoice. Hence, registered vendors may demand full invoices instead.

Return

Taxpayers are required to submit returns for each accounting period, which can be two weeks, or one, two, three, or six months long, depending upon the revenue requirement, administrative capability, need for refund, and so on. While shorter return periods pressure taxpayers into paying their taxes on time, longer ones reduce both compliance and administrative costs and avoid the problems related to credit sales and taxpayer resistance. However, particularly for small vendors, shorter periods are preferable because the longer the tax period, the higher the chance that the tax money will be used in consumption and hence that taxpayers will become bad taxpayers. Additionally, longer tax periods both increase the amount of tax collected and due (hence the incentive/greed not to pay the tax) and cause cash flow problems for the government. So in deciding between longer and shorter return periods, the government faces a trade-off between administrative and compliance cost issues on one hand, and timely money collections on the other. In the case of exporters, the accounting period needs to be even shorter to avoid a cash flow problem; since taxes are not collected on exports, financing the refunds for the input tax credits claimed is difficult.

Because of revenue reasons, and under the influence of the monthly sales tax return system, Nepal adopted a monthly return system. However, to both encourage registration and reduce compliance and administrative costs for the taxpayers that register voluntarily, the return period

is a trimester (in this way taxpayers can hold tax money for a maximum period of five months).

Generally, registrants are required to file a consolidated VAT return that accounts for all their commercial activities. However, some countries allow corporations and some organizations with distinct (and separate) divisions to apply for the permission to file separate returns for their branches or divisions. Permission to do this is generally granted when the divisions/branches have separate accounting systems and are identifiable by activity or location. Under the Nepalese VAT system, however, there is no such provision; the head office is required to file a single return with the sales and purchases made by all its branches.

Under VAT, the case for having an annual return is weak. VAT is a transaction-based tax reported and paid in the reporting period when the transaction occurred. A few countries have, nevertheless, made provisions for an annual return. The reason for this is that if there are mistakes in the monthly returns, tax officials can correct them in the annual one. However, if a mistake in a monthly return is not corrected on time, it is unlikely that it will be corrected in an annual return. Moreover, a system of both annual and monthly returns is time consuming and costly for the administration and businesses alike. In fact, the annual return is usually just a way in which governments make arbitrary assessments in an attempt to raise additional revenue at the end of the fiscal year.

Since the idea was to make the tax system simple and to get rid of as many tax formalities as possible, there has been no provision for an annual return in Nepal. Instead, the tax administration is to monitor non-filers and non-timely taxpayers, and to create a computerized assessment for each non-filer during each accounting period when the return is not received.

Payment

Taxes can be paid in banks, in tax offices, or both. However, payments made in tax offices run the risk of not being properly recorded, while those made in banks are safer, because the banks have developed systems to maintain proper records. In Nepal, the taxes have to be paid in banks; there are banks in all the places where VAT offices are located and they accept both cash and checks.

Another question that arises is whether the payment voucher should accompany the return. If this is the case, then taxpayers are pressured into paying their taxes on time, because otherwise they would suffer double penalties: both for not having submitted the return and for not having paid the tax. However, this system is not fault-free either. If returns are accepted only if accompanied by the proof of payment, then the taxpayers that (for one reason or another) cannot pay their taxes will be unable to submit their returns either, thus depriving the tax administration of valuable information on their taxable activities.

It should be noted here that the return is merely the declaration of a liability and not its actual payment. Hence the two should be treated as separate events so as not to discourage taxpayers from disclosing their liabilities (though, of course, tax officials could encourage the submission of returns accompanied by payments). In this way, if the taxpayers do not pay their taxes, they will be subject to the penalties (including interest) for nonpayment, but not to those for non-filing. This would even ease the work of tax officials, since they could follow up and take further actions. On the other hand, this might induce taxpayers to submit their returns without paying the taxes due and thus escape the penalty for non-filing and diminish their overall burden for nonpayment. However, the interest and penalties for nonpayment are high in Nepal, and the tax administration is expected to take prompt action in such cases. As a consequence, in Nepal it was decided not to tie the submitting of returns to the actual payment of taxes.

Refund

The credibility and success of the VAT system depend upon the adequate functioning of a refund of excess input credits system. Hence, such a system needs to be carefully designed and properly implemented. In designing the refund system in Nepal, factors like export promotion, administrative feasibility, and revenue were all carefully considered. The resulting conclusions—about when refunds should arise under the Nepalese VAT—are summarized below:

- A person who exports more than 50 percent of his total sales during any month is entitled to claim refunds.
- A person who has an excess of tax credits during a period of six consecutive months is also entitled to claim refunds.

- Accredited diplomats, foreign agencies, and foreign-funded projects are also entitled to refunds of the VAT paid on their purchases.

A tourist refund scheme was also discussed and developed, but ultimately it was not adopted. Tourism is a large part of the economy in terms of generating employment. Trekkers spend on average about \$8 per day (probably on lodging and consumables) for a period of, on average, twelve days. A tourist VAT refund system might result in numerous claims, but the total amount may not be large, leading to high administrative costs and exhausting the department's limited human resources. We should also bear in mind that a 10 percent VAT would not make much of a difference to rich tourists. Handicrafts, one of the major tourist exports, are exempted from VAT and so are their inputs. Since the handicrafts are usually bought from small retailers who are not registered (being below the threshold) the amount of VAT to be refunded may be very small. Handling a tourist refund scheme is difficult in itself, but the cross-border trade with India and the foreign exchange control system further complicate things. Furthermore, tourist refunds could easily lead to a revenue loss and an open loophole for fraud. Consequently, some countries (like Singapore) fix a minimum refund limit, while others (like Cyprus, Fiji, and Thailand) do not have a tourist refund system at all— though the tourism sectors in these countries continuously lobby for one.

Appeal System

Under a modern tax system like VAT, an efficient appeal system must also be established. Since the Revenue Tribunal in Nepal, which had been set up to handle tax-related cases, had not been functioning efficiently and since it was not easy to streamline it immediately, setting up a revenue consideration board was considered. This board must announce its decision within one year after the date of application (in which case the taxpayers would have to submit the specified), or the decision would be considered to be in favor of the taxpayers. This proposal was ultimately dropped in the parliament; nevertheless, it should probably be included in future amendments to the law in Nepal, and is recommended for implementation in any developing country implementing a VAT.

VAT Development²⁵

The idea of introducing a VAT in Nepal was recommended by the Task Force on Economic Policy Reform appointed by the government in 1991.²⁶ The Eighth Plan document prepared in 1992 also emphasized adopting a VAT (in the place of several minor commodity taxes) in order to establish a sustainable source of government revenue. VAT has also been recommended in one form or the other in most budget speeches since 1992/93.

The entire process began in September 1993 when a VAT task force was called upon to make the necessary preparations for the introduction of VAT. A VAT steering committee was also set up to evaluate and monitor the VAT preparatory activities.²⁷

The VAT law was drafted in 1994, after having been discussed in depth at several stages with the VAT task force, the Secretary of the Law Reform Commission, and various business groups. The draft was then reviewed by the VAT Steering Committee and sent to various business groups—including the Federation of Nepal Chamber of Commerce and Industry (FNCCI)—for comments.

On December 3, 1995, the VAT bill was presented to the parliament. It was referred to the Finance Committee, which discussed it on December 24, 25, and 26, 1995. On December 27, 1995, the Finance Committee sent the VAT bill back to the parliament, together with its report for the amendment of a few provisions. The Lower House of Parliament passed the VAT bill on December 30, 1995, and the Upper House of the Parliament passed it on January 4, 1996. Finally, the VAT bill got the royal seal on March 20, 1996.

The VAT regulations were drafted in July 1996. Like the VAT bill, the regulations were discussed at different stages and were finally passed by the Cabinet on January 27, 1997.

The operational manual was initially drafted in 1996 and was finalized in the fall of 1997. The Government of Nepal approved it on September 21, 1997. The manual facilitates daily administration and reduces the risk of different interpretations of tax laws by different officials. A number of computer user manuals have been produced as well.

Taxpayers Education Program

Before the tax was introduced, a comprehensive VAT educational program was launched, which intensified in 1996 and 1997. The initial focus of these programs was explaining to the business community the rationale and the working of VAT, and getting input from them for the refinement of the draft VAT law.

At later stages, the educational programs were extended to other categories of the population, including consumers and parliamentarians. The main activities carried out in this respect included the following:

Interaction Programs

Seminars and public speeches were organized in different places for various groups. For example, the members of VAT interaction groups came from the FNCCI, and several district chambers of commerce and industry, commodity associations, and professional organizations. Similarly, VAT presentations were made during programs arranged by different bodies and organizations, including training centers, universities, campus organizations, schools, rotary clubs, professional bodies, UN organizations, members of parliaments, diplomats, journalists, and so on.

Brochures, Articles, Posters, and Video Films

Several brochures in both English and Nepali were also prepared and distributed on a large scale. Complementing these brochures, many national newspapers published articles on various aspects of VAT. Different posters, three VAT video films, and many television and radio programs were also prepared.

Information was disseminated through the media on a large scale. In 1997 a local advertising company was hired to carry out information campaigns through media as diverse as television, radio, newspapers, posters, brochures, etc. Basic information like the date of the introduction of VAT, the period within which taxpayers must register, the deadline for submitting returns and tax payment, the description of the VAT accounting system, and the penal provisions, were

widely advertised through the media.

Visits/Telephone Calls

An extended VAT information service was also provided to both business callers and the general public. Attempts were also made to educate taxpayers through visits made by tax officers.

Administration, Computerization, and Training

Organizational Structure

The Sales Tax and Excise Administration was made responsible for the administration of VAT, and eighteen field offices were set up under this department. Its organizational structure was not functional, however; the same officer was responsible for registration, assessment, and collection, which made the system corruption-prone.

Since this organizational structure was not adequate for the implementation of VAT, it was recommended to adopt an organizational structure based on functional line and hierarchy of personnel responsibility.²⁸ The new system was largely accepted and hence in July 1996 it was approved and implemented. Under the new structure, on the basis of the function of VAT administration, several sections and subsections were created; among these, most important are the large taxpayer, tax refunds, taxpayer services, tax audit and investigation, internal monitoring, collection, registration, and computer sections. In all, there are seventeen field offices under the VAT Department.

Computerization

To effectively implement the VAT, it is essential to computerize its administration. For example, though the tax audit is an integral part of the administration of VAT, it is, nevertheless, impossible to verify information about all the taxpayers and hence some criteria must be developed for the selection of audits. Computerization helps in this respect by selecting suspect cases for auditing (which would be very difficult to do manually) and by detecting non-filers, non-payers, and so on. In light of these issues, a comprehensive computerization system has been developed in Nepal.

The VAT Department was the first to be computerized in the revenue administration. A local area network (LAN) was established in the department and several modules such as registration, returns, payments, refunds, computerized accounting systems, and computer generated assessments for taxpayers that failed to file tax returns. The computer selection of taxpayers for verification and audit were also developed, tested, and implemented.

Under the centralized data processing system, documents like the application for VAT registration, VAT returns, and payment vouchers are received first by the VAT offices and then are batched to the VAT Department. Data entry and processing is done in the computer section of the VAT Department and the necessary printouts are then sent to the VAT offices. The computer system provides items like registration certificates, a registrants' list, a non-filers list, posting reports, outstanding reports, audit trial reports, refund claims, revenue reports, suspended reports, and closing reports, all of them generated by the taxpayers and by VAT offices.

After gaining some experience in central-level computerization, it was decided to computerize field offices as well in several phases. This process began on an experimental basis in September 1998 and was completed by March 1999. Under the decentralized system, the VAT offices enter data and transmit them to the Central Department, which in turn validates the batches transmitted by the VAT offices, posts the data into the taxpayers accounts, and transmits the outputs back to the VAT offices.

The decentralized data processing system has helped to provide data on time, and since the computerization is done at the VAT offices, the time lost with mailing (two weeks or more in some cases) was eliminated as well. Moreover, under this system it is easier for the tax officers to correct errors since they can obtain data by simply telephoning or visiting the concerned taxpayers under their area of jurisdiction. Taxpayers are also better served since their accounts are updated regularly.

Personnel System

The personnel system of the Sales Tax and Excise Administration was not adequate for the implementation of VAT either. Out of the total 471 posts, 47 were gazetted (officer level) and

424 non-gazetted (assistant level—including typists, drivers, and peons). The very large number of non-gazetted level posts were occupied by officials with very low levels of education and who had previously worked for the excise administration—run under the physical control system.

The examination of the personnel system in light of the VAT implementation resulted in the recommendation of a new personnel system. Consequently, the number of gazetted officers increased to 120, while the number of non-gazetted personnel was reduced to 261, including accountants, computer operators, and 113 are peons/drivers. (The total number of staff increased only marginally, that is, from 471 to 494). Most of these changes occurred before the introduction of VAT.

Training

Since VAT was a new concept in Nepal, it was decided that before assigning particular jobs to the officers recruited for the VAT administration, they should first be trained on various aspects of VAT. Consequently, various training programs were organized not only for the VAT personnel, but also for the officials of other organizations, which are directly or indirectly involved in VAT implementation.

The training programs continued even after the introduction of VAT; the ones organized before the introduction of VAT were more general, while those organized afterwards were more specific, addressing issues like refunds, collection, accounting, and auditing. In addition, every two months, workshops for the chiefs of VAT offices were also organized, with the purpose of sharing experiences, discussing implementation problems, finding out solutions, and informing the chiefs about the new procedures. Also, some officials were sent to Bangladesh, Indonesia, Canada, Singapore, Denmark, and Thailand (to study the VAT systems in these countries) and to the Netherlands and Germany (to attend VAT courses and to observe the operation of the Dutch and German VAT systems).

A number of training programs also focused on computerization. The training (of data entry clerks and others) was first provided with the use of the registration module and later with batching procedures and various aspects of the VAT application.

VAT Implementation

Initially it was planned to implement the VAT Act in mid-April 1997 and to give taxpayers a period of ninety days for registration. Hence, VAT was supposed to be collected starting with the beginning of the fiscal year 1997/98 (July 16, 1997). However, due to the government change in April 1997, the introduction of VAT was postponed for four months. According to the new schedule, the VAT Act came into force on November 16, 1997,²⁹ when the Sales Tax Act 1966³⁰ was repealed. The import/manufacturing level sales tax was converted into VAT on this date as well.

Registration

The sales tax registrants³¹ were required to register for VAT by November 16, 1997, while other firms were given ninety days (starting with November 16, 1997) to do it. Most of the sales tax registered firms registered for VAT by the due date, while a few others did so only after some action initiated by the VAT administration. Also, a few new firms came into the VAT net. In all, the number of VAT registrants on February 13, 1998—the deadline for compulsory registration for VAT—reached 3025. This number increased gradually, reaching about 5000 by the end of the fiscal year 1997/98 (July 15, 1998), around 6500 by the end of 1998, and about 15,000 by September 1999.³²

Return Submission/Non-filers

According to the VAT law, taxpayers are required to submit returns within twenty-five days of the expiring of the tax period (a trimester for voluntary registrants and one month for the others). A large number of taxpayers submit returns within the due date. These returns are being scrutinized on a regular basis. VAT returns are received in three forms: debit, credit, and zero returns. Until now, the number of credit returns has been higher than that of debit returns, but this situation will reverse itself once VAT becomes fully operational.

There are also non-filers whose percentage varies from month to month. The non-filers are mainly those small taxpayers (particularly small contractors), whose turnover is lower than the threshold, but who have nevertheless been registered under the VAT due to the requirement of

submitting a copy of the VAT registration certificate at the time of bidding government contracts. These non-filers have been reminded to file their returns.

VAT Visits/Audits

With a view to introducing taxpayers to VAT formalities, VAT officers visited taxpayers both before and immediately after the introduction of VAT.

VAT officials also visited several taxpayers a few months after the implementation of VAT, but this time the objective of their visits was the verification of records. The tax officers have to prepare reports for each visit and keep them in the taxpayers' files in the district office.

During the verification visits, tax officers discovered several errors in the VAT records maintained by taxpayers. For example, in some cases purchase books and sales books were not maintained as required, while in others they had not been certified by tax officers. Also, the taxpayers had used computer accounting systems without prior approval from the tax office, had not prepared invoices as specified by the VAT regulations, had not printed or stamped the words "tax invoice" on the top copy, had claimed tax credit on the basis of the second copy of the invoices, had claimed full credit even when they had used a part of their inputs in producing exempt supplies, had not charged VAT on goods exchanged through barter systems and had not recorded such purchases or sales in their books, had claimed import duties as credit, or had not shown tax paid on telephone bills. Since taxpayers were informed about these mistakes, the number of errors decreased a few months after the VAT implementation.

Since tax auditing is a new concept in Nepal, several attempts were made to establish an audit system. To this view, in March 1998, the VAT Department set up an audit core group in order to discuss and review audit procedures on a regular basis. This group developed several criteria for the selection of taxpayers for audit. After one year of VAT implementation a couple of firms were selected for a detailed audit. Auditors found several cases of tax avoidance or evasion and recovered through audits some additional revenue.

Revenue Collection

VAT generated a revenue of Rs 7,123 million in 1997/98 and revised estimate for 1998/99 is Rs 8,035 million. This tax is expected to generate Rs 10,460 million in 1999/2000, of which Rs 6,050 million will be collected on imports at customs points and the rest from VAT registrants. This means that about 58 percent of total VAT revenue will be collected from imports and about 42 percent from domestic VAT registrants.

Concluding Observations

The reform process in Nepal that converted the domestic indirect tax system from a nineteenth-century style system of excise taxes into a modern VAT and excise tax system has been fundamental in nature. Both the tax policies and the tax administration have had to be reengineered. The design of the new tax structure and administration took into consideration, the nature of the economy and the country's present stage of development.

Many of the issues faced in the design of the indirect tax system and its administration are common to most poor developing countries that are modernizing their tax systems. This paper has reviewed several of these issues along with providing the rationale for what was adopted in Nepal.

Only time will decide whether this reformed tax system will take root and become the foundation for future improvements, or slide back to the excise tax approach that has historically characterized taxation in Nepal.

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Appendix 1. Schedule of Activities in the VAT Preparation and Implementation Process in Nepal.

	-	Eighth Five year plan (1992/93–1996/97) announced a policy of adopting VAT.
July 11, 1993	-	The 1993/94 budget states that VAT will be introduced within a year or two.
September 1993	-	The VAT Steering Committee and the VAT Task Force are formed; start of Harvard Institute for International Development's Technical Assistance, financed by USAID. This collaboration with HIID was suspended in 1995, resumed in February 1996, and continued until September 1997. Beginning with 1997, technical assistance has been provided by Danish International Development Agency (DANIDA)
March 7–27, 1994	-	The first VAT training for tax officers takes place in Kathmandu; since then, courses on VAT have been organized in various places.
April 24, 1994	-	The first VAT interaction program in collaboration with FNCCI; similar programs have been organized several times since then.
May 15, 1994	-	The first VAT interaction program in collaboration with Nepal's Chamber of Commerce. Since then, several interaction programs have been organized with both Nepal's Chamber of Commerce and various district chambers of commerce and industry from all over the kingdom.
July 14–16, 1994	-	The first VAT training program for the representatives of FNCCI. Similar programs have been organized several times since then.
October 30, 1995	-	The VAT steering committee is reconstituted.
December 3, 1995	-	The VAT bill is presented to the Lower House of the Parliament.
December 24–26, 1995	-	VAT bill is discussed in the Economic Committee of the Parliament.

- | | | |
|------------------------|---|---|
| December 27, 1995 | - | The Chairman of the Economic Committee of the Parliament submits a report on the VAT bill to the Lower House of the Parliament. |
| December 30, 1995 | - | The VAT bill is passed by the Lower House of the Parliament. |
| January 4, 1996 | - | The VAT bill is passed by the Upper House of the Parliament. |
| March 3, 1996 | - | The first VAT interaction program in collaboration with pharmaceutical associations. Since then, interaction programs have been held with the majority of commodity associations. |
| March 11–12, 1996 | - | The VAT training program for journalists is instituted. |
| March 20, 1996 | - | The royal ascent is given on the VAT bill. |
| July 16, 1996 | - | The conversion of the Sales Tax and Excise Administration into the VAT Administration takes place. |
| August 12 and 20, 1996 | - | The VAT interaction program for members of the Parliament takes place. |
| September 17, 1996 | - | The VAT interaction program with the Chartered Accounts Association begins. Since then many VAT interaction programs have been organized for several other professional groups. |
| November 14, 1996 | - | A VAT Task Force, with members from the VAT administration, FNCCI, and the consumer forum is set up. |
| January 24, 1997 | - | The Cabinet approves the VAT Regulations. |

- March 24, 1997 - The National VAT Steering Committee, consisting of representatives from HMG/N, FNCCI, and Donor is formed.

- August 1, 1997 - The VAT Task Force with members from HMG/N, as well as industry and commerce sectors, is formed.

- September 21, 1997 - The VAT manual is approved by HMG/N.

- November 16, 1997 - The VAT Act comes into force.

- December 15, 1997 - A VAT technical group is formed to solve VAT implementation problems.

- February 13, 1998 - The ninety-day period for compulsory VAT registration is completed.

- April and May 1998 - The government and the private sector representatives discuss (on several occasions) various tax issues, including VAT.

- July 10, 1998 - Several new provisions regarding VAT are introduced through the Finance Bill of 1998.

- September 1, 1998 - The government and the private sector representatives reach an agreement—known as “39-points agreement”—on various tax issues, including VAT.

Appendix 2. The Date of the Introduction and the Existing Rate(s) of VAT in Different Countries.

Countries	Date of VAT Introduction	Tax Rate(s) 1998		
		Higher Rate(s)	Standard Rate	Lower Rate(s)
<u>EUROPE</u>				
<i>(i) EC</i>				
Denmark	3 July 1967		25.0	
France	1 January 1968		20.6	2.1, 5.5
	(limited VAT 1954)			
Germany	1 January 1968		16.0	7.0
The Netherlands	1 January 1969		17.5	6.0
Sweden	1 January 1969		25.0	6, 12
Luxembourg	1 January 1970		15.0	3, 6, 12
Belgium	1 January 1971		21.0	1, 6, 12
Ireland	1 November 1972		21.0	2.8, 12.5
UK	1 April 1973		17.5	2.5, 8.0
Austria	1 January 1973		20.0	10
Italy	1 January 1973		19.0	4, 10, 16
Portugal	1 January 1986		17.0	5, 12
Spain	1 January 1986		16.0	4, 7
Greece	1 January 1987		18.0	4, 8
Finland	1 June 1994		22.0	6, 12, 17
<i>(ii) Non-EC</i>				
Norway	1 January 1970		23.0	
Turkey	1 January 1985	23	15.0	1.0
Iceland	1 January 1990		24.5	14.0
Estonia	10 January 1991		18.0	
Russia	1 January 1992		20.0	10.0
Uzbekistan	14 January 1992		20.0	10.0
Tajikistan	1 January 1992		20.0	
Belorussia	1 January 1992		20.0	10
Ukraine	1 January 1992		20.0	
Kazakhstan	1 January 1992		20.0	
Moldova	January 1992		20.0	
Kyrgyzstan	March 1992		20.0	
Cyprus	1 July 1992		8.0	
Slovak Republic	1 January 1993		23.0	6.0
Czech Republic	1 January 1993		22.0	5.0

Countries	Date of VAT Introduction	Tax Rate(s) 1998		
		Higher Rate(s)	Standard Rate	Lower Rate(s)
Hungary	1 January 1993 (1988)		25.0	12.0
Azerbaijan	1 June 1993		20.0	10.0
Armenia	1 July 1993		20.0	
Romania	1 July 1993		22.0	
Poland	5 July 1993		22.0	12.0, 7.0
Turkmenistan	1 November 1993		20.0	
Georgia	24 December 1993		20.0	10.0
Bulgaria	1 April 1994		22.0	
Lithuania	1 May 1994		18.0	9.0
Switzerland	1 January 1995		7.5	2.3
Liechtenstein	1 January 1995		6.5	2.0
Latvia	1 May 1995		18.0	
Malta	1995 (abolished with effect of 1 July 1997)		15.0	10.0
Albania	1 July 1996		12.5	
Macedonia	1 January 1999		24.0	5.0
Croatia	1 January 1998		22.0	
Slovenian	1 January 1999			
<u>SOUTH AMERICA</u>				
Brazil	January 1967		Various rates	
Ecuador	1 August, 1970		10.0	
Paraguay	1 July 1992 (1968)		10.0	
Uruguay	29 December 1972 (1968)		23.0	14.0
Bolivia	October 1973		13.0	
Argentina	January 1975		21.0	10.5
Chile	March 1975		18.0	
Colombia	January 1975	60,45,35,20	16.0	8.0, 15.0
Peru	1 November 1981 (1976)		16.0	
Venezuela	1 October 1993	32.5, 22.5	16.5	
Surinam	1 February 1998		7.0 For goods and 5 for services	
<u>NORTH AMERICA</u>				

Countries	Date of VAT Introduction	Tax Rate(s) 1998		
		Higher Rate(s)	Standard Rate	Lower Rate(s)
Costa Rica	January 1975		15.0	5.0
Nicaragua	January 1975		15.0	5, 6, 10
Honduras	January 1976	10.0	7.0	
Panama	March 1977	10.0	5.0	
Mexico	1 January 1980		15.0	10.0
Haiti	November 1982		10.0	
Grenada	January 1987		27.5	5.0
Trinidad and Tobago	1 January 1990		15.0	
Canada	1 January 1991		7.0	
Dominican Republic	1 June 1992		8.0	
Guatemala	1 July 1992 (1983)		10.0	
El Salvador	1 September 1992		13.0	
Belize	April 1996		15.0	
Barbados	1 January 1997		15.0	7.5
<u>AFRICA</u>				
Ivory Cost	January 1960		18.0	10.0
Senegal	March 1961		20.0	10.0
Niger	1 January 1986		17.0	
Morocco	1 April 1986		20.0	7,12,14
Tunisia	2 June 1988	29.0	17.0	6, 10
Malawi	May 1989	40.0	20.0	10.0
Kenya	1 January 1990		17.0	12.0
Mali	1 January 1991		15.0	10.0
Benin	1 April 1991		18.0	
South Africa	30 September 1991		14.0	
Jamaica	22 October 1991		15.0	
Algeria	1 April 1992	21.0	13.0	7.0
Burkina Faso	1 January 1993		18.0	
Nigeria	1 January 1994		5.0	
Congo	1 April 1994		17.0	5.0
Madagascar	September 1994		20.0	5.0
Mauritania	1 January 1995		14.0	5.0
Togo	10 March 1995		18.0	
Gabon	1 April 1995		18.0	
Ghana	1 March 1995 1 January 1999		10.0	
Zambia	1 July 1995		20.0	
Uganda	1 July 1996		17.0	
Guinea	July 1996		18.0	

Countries	Date of VAT Introduction	Tax Rate(s) 1998		
		Higher Rate(s)	Standard Rate	Lower Rate(s)
Mauritius	September 1998		10.0	
Tanzania	1 January 1998			
Tunisia			18	
<u>OCEANIA</u>				
New Zealand	1 October 1986		12.5	
Fiji	1 July 1992		10.0	
Western Samoa	1 January 1994		10.0	
Papua new guinea	1 January 1999			
Australia	1 July 2000		10.0	
French Polynesia	1 January 1998		3.0 for services and 2.0 for goods	1.0
Vanuatu	1 August 1998		12.5	
<u>ASIA</u>				
Vietnam	1 July 1973, abolished soon, proposed from January 1, 1999			
Israel	1 July 1976		17.0	6.5
South Korea	1 July 1977		10.0	
China	1 January 1994		17.0	13.0
	(1 October 1984)			
Indonesia	1 April 1985		10.0	
Taiwan	1 April 1986		5.0	
Morocco	April 1986		20.0	14.0, 10.0, 7.0
The Philippines	1 January 1988		10.0	
Japan	1 April 1989		5.0	
Pakistan	1 November 1990		15.0	
Bangladesh	30 July 1991		15.0	
Thailand	1 January 1992		10.0	
Mongolia	1 July 1998		13.0	
Singapore	1 April 1994		3.0	
Nepal	16 November 1997		10	
Sri Lanka	1 April 1998		12.5	

Sources: Various publications of the International Bureau of Fiscal Documentation.

Endnotes

¹ Kwang Choi, "Value Added Taxation: Experiences and Lessons of Korea," *Asian-Pacific Tax and Investment Bulletin* 2(6), 1984, p. 231.

² The list of VAT countries is given in Appendix 2 to this paper.

³ A highway improvement fee was introduced in 1992/93, while a health tax was introduced in 1993/94. A liquor control service charge was included in the domestic indirect tax family in 1996/97. An SAF Game Fee was introduced in 1996/97—abolished in 1997/98 but reintroduced in 1998/99. A motion picture development fee and a tourism development fee were adopted in 1998/99.

⁴ In 1991/92, a self-removal procedure was introduced on an experimental basis in place of the physical control system. The new system was to be applied to a few specified items. Under the self-removal system, no excise inspector was posted at the factory; the manufacturer could assess excise himself, collect it from the customer, and remove goods without the prior approval of excise officials. In order to adopt this system, a manufacturer had to complete such steps as (a) apply to the excise office concerned in the prescribed manner; (b) keep account of raw materials, semi-processed goods, finished goods, and goods removed from his warehouses in a prescribed manner; and (c) furnish information about the ex-factory price of his goods to the chief of the excise office at least three days before effecting any removal.

The new system, however, was bureaucratic and as result was not attractive to the manufacturers. Further, under the proposed system they would have to be fully responsible for excise assessment and payment and could not share the responsibility of tax evasion, etc. with the excise inspector. The system was complicated as well since the manufacturers were required to furnish information about the ex-factory prices of their products to the excise administration before effecting any removal of the goods. As a result, this system was never put into general operation. Now excises are basically levied on tobacco products and alcoholic beverages, which are subject to the physical control system.

⁵ In 1992/93, a two-tier system of sales taxes was introduced for selected domestic products. Under this system, dealers and distributors of nine selected items (i.e., beer, biscuits, cigarettes, noodles, quality liquors, soft drinks, vegetable oil and ghee, and woolen yarn) were also required to register for sales tax purposes and collect tax on their sales. They were given credit for taxes paid on their inputs. Manufacturers of these products did not have to pay advance sales tax on the import/purchase of their raw materials, auxiliary raw materials, and chemicals, meaning that in their case the suspension system was adopted. The scope of the two-tier system was extended to another five items (cement, iron rods, paints, plain, and corrugated sheets and soap) in 1993/94 when sole distributors or agents of the foreign firms or companies and their wholesalers also became liable to register for sales tax purposes. Now all sales-tax-registered vendors had to pay a sales tax on their imports or purchases from other sales-tax-registered vendors, meaning that the suspension system introduced in 1992/93 in the

case of the manufacturers of the nine items mentioned above was discontinued. The tax paid on inputs was credited against their output tax.

While the new system was expected to broaden the tax base by bringing the value added at the wholesale/dealer level into the tax net, it was subject to severe criticism by the business community on the grounds that it was discriminatory, that is, being levied on the value added at the wholesale and dealer levels of only a few selected items. Manufacturers of the items subject to the two-tier sales tax also faced situations when the dealers were not registered for the sales tax and did not like to buy goods with an issuance of an actual invoice. This might have been due to the suspicion that such information would help tax authorities assess their income tax. This led to a mark-up system in which the manufacturer price was uplifted by a certain percentage for sales tax purposes and the dealers were not registered. Margins for sales tax purposes were fixed arbitrarily and became an issue of controversy. This also led to double taxation in the case of sales by registered manufacturers from non-registrants. Because of all these reasons, the two-tier sales tax was abolished hastily in 1994/95.

6 Glenn P. Jenkins and George Kuo, "Revenue Implications of Rates and Base Specifications for Proposed VAT System in Nepal," Harvard Institute for International Development, Cambridge, MA, 1996.

7 R. W. Lindholm, The Value Added Tax: A Short Review of the Literature, *Journal of Economic Literature*, Vol 8, 1970, p. 1180.

8 Excises and sales tax were exempt on domestically produced goods sold in convertible foreign currencies in the local market.

9 Cottage industries were exempt from the sales tax system.

10 Alan A. Tait, "Value Added Tax: International Practice and Problems," International Monetary Fund, Washington, D.C., 1988, p. 16.

11 Income and gross domestic product VAT types put additional burdens on investment. Under the income-type VAT (but not under the gross product one), depreciation is excluded from the tax base in the following years. This means that the burden of gross domestic type VAT falls on business investment, causing changes in the techniques of production, and providing an incentive for the substitution of labor for capital. The income-type VAT requires the preparation of depreciation tables, demanding additional effort. Under both the income and gross domestic types, taxpayers may try to classify capital goods as non-capital goods in order to receive more input tax credits. Both types complicate tax administration.

12 According to the VAT Act of 1996, the excess credit must be carried forward to offset VAT taxes due in cases other than exports and refunded only if the taxpayer has been in an excess credit position for a period of six consecutive months.

13 For details see Glenn P. Jenkins and George Kuo, op. cit., 1996.

14 *Ibid.*

15 Organization for Economic Co-operation and Development, Consumption Tax Trends, OECD, Paris, 1995, p.19.

16 John F. Due and Francis P. Greaney, "The Introduction of a Value-added Tax in Trinidad

and Tobago,” in *Improving Tax Administration in Developing Countries*, edited by Richard M. Bird and Milka Casanegra de Jantscher, International Monetary Fund, 1992, p. 188.

17 John F. Due, “A General Consumption Tax,” in *The Jamaican Tax Reform*, edited by Roy Bahl, Lincoln Institute of Land Policy, Cambridge, MA, 1991, p. 481.

18 Allan A. Tait, op. cit. 1988, p. 93.

19 Organization for Economic Co-operation and Development, “Taxing Consumption,” OECD, Paris, 1988, p. 175.

20 Ministry of Trade and Industry and Ministry of Finance, “The Goods and Service Tax,” Singapore, 1993, p. 22.

21 Organization for Economic Co-operation and Development, *Consumption Tax Trends*, OECD, Paris, 1995, p.28.

22 Alan A. Tait, op. cit., 1988, p. 93.

23 Charles E. McLure, Jr., “The Value Added Tax Key to Deficit Reduction?” American Enterprise Institute for Public Policy Research, Washington, D.C., 1983, p. 137.

24 Ministry of Trade and Industry and Ministry of Finance, “The Goods and Service Tax,” Singapore, 1993, p. 23.

25 Schedule of activities in the preparation and implementation of VAT is given in Appendix 1 to this paper.

26 Prior to this, the idea of a VAT appeared in a few articles and in the IMF mission reports in the 1980s. The feasibility of introducing a VAT in Nepal, including an outline of the structure and operation of a proposed VAT in Nepal and the preparations made for its introduction were all explored in greater detail in Rup Bahadur Khadka, *VAT in Asia and the Pacific Region*, International Bureau of Fiscal Documentation, Amsterdam, 1989, Chapter 5.

The idea of introducing a VAT in Nepal was further explored by a Harvard Institute for International Development (HIID) team that visited Nepal under the CAER (Consulting Assistance for Economic Reform) Project in April–May 1993. Its report outlined the tax policy and administrative steps that might be considered for strengthening the tax system of Nepal. In particular, it recommended the establishment of a modern VAT system with a single rate of tax, few exemptions and excise duties, and a tax administration benefiting from improved information, collection, and investigative facilities. Glenn P. Jenkins, *Preparing for the Introduction of VAT in Nepal*, Harvard Institute for International Development, May 1993.

27 Since then VAT task forces and steering committees were formed or reorganized several times in connection with the preparation and implementation of VAT. The United States Agency for International Development (USAID) provided financial assistance (under its CAER-I Project) for the preparation and implementation of the VAT process in Nepal. Under this project, Harvard Institute for International Development’s technical assistance began in the fall of 1993. Members of the VAT task force and the HIID consultants worked together. USAID/HIID assistance was supposed to last until August 1996.

However, in late 1994 a government change took place, and in the beginning the new

government did not show the same commitment to implementing VAT. As a result the activity of USAID was suspended in early 1995. Nevertheless, this government kept the possibility of introducing VAT open. This made it easy for the new coalition government, formed in late 1995, to make the decision to introduce VAT. As a consequence, HIID technical assistance resumed in February 1996 under USAID's CAER Project for a period of about eight months. The HIID/USAID assistance was later extended and continued until the end of September 1997. Assistance for the implementation of the VAT was continued beyond September 1997 through financing provided by the Danish government.

28 It was very difficult to obtain approval for the new organizational and personnel system from the Ministry of General Administration, which was blocking the work without any reason.

29 1 Marg 2054 according to Nepali Calendar.

30 The Hotel Tax Act of 1961, the Contract Tax Act of 1966, and the Entertainment Tax Act of 1959 were also repealed on November 16, 1997. The entertainment tax, however, continued to be levied under the Finance Act of 1997 even after the introduction of the VAT. Similarly, contractors were given the option to pay the contract tax (under the Finance Act of 1997) or to come under the VAT regime (in the case of contract signed before the introduction of VAT).

31 The number of sales tax registrants was 2045 in mid-November 1997.

32 VAT registration has been affected by the opposition from the business community. In response to this opposition, many compromises, including the provision of voluntary registrants by retailers, were made. As a result the VAT is not effectively implemented at the dealer and retail points. The exemption of many items from VAT and the increase in the level of threshold also has affected registration.